Business In The Beltway

A Retirement Revolution

Jessica Holzer, 08.04.06, 5:00 PM ET

WASHINGTON, D.C. - It's a very big deal.

When the Senate passed its pension reform package late Thursday night, it created what will likely be the biggest change in the way Americans prepare for retirement in a generation. It will speed the death of traditional pensions while spurring enrollment in other retirement savings vehicles.

Now awaiting the president's signature, the new rules will make it easier for employers to automatically enroll workers in 401(k) plans and will lift a legal cloud surrounding cash-balance plans.

The result is a clearer path for employers as they contemplate how to compensate their workers, argues Joel Rich, an executive at the Segal Co., a human resources and benefits consulting firm.

"What the bill is going to do is make employers rethink their entire strategy," he says. "It introduces more viable options, and it also clarifies incentives."

For many companies, the legislation means higher contributions to their traditional pension plan. At present, these pensions are underfunded to the tune of $450 billion. Aside from the airlines, which succeeded in winning special breaks on the tighter rules, companies will have seven years to make up any shortfall.

This mandate is accompanied by other rules that will increase the volatility of plan contributions. At the same time, a separate accounting change that takes effect at the end of the year will require companies to reflect the funded status of their pension obligations on their balance sheet. All told, these changes will make it more complex to manage a traditional pension plan.

"This gives investors a lot more information, but it's also going to accelerate the trend toward employers freezing and terminating plans," says Howard Silverblatt, a senior analyst at Standard & Poor's.

Those companies that stick with the plans will likely turn to tools to help them model the asset risks and deal with the volatility, predicts Rich.

The hope is that the stricter funding rules will help to diminish the risk of a taxpayer bailout of the Pension Benefit Guarantee Corp., the funder of last resort for the pension system. The agency is $23 billion in the hole after a string of bankrupt companies such as **United Airlines** and Delphi saddled it with their pension obligations. While the PBGC isn't explicitly backed by the government, few doubt that taxpayers would be called upon to pick up the tab in the event of bankruptcy.

But many retirement experts suspect that the provisions affecting 401(k) plans will have the biggest impact over time.

"I think the automatic 401(k) provisions have the potential in the long run to be the most consequential part of the legislation," argues Mark Iwry, a senior adviser to the Retirement Security Project in Washington.

Currently, 75% of workers who are offered a 401(k) plan sign up, but with automatic enrollment, the rate shoots up to 95%. Besides encouraging employers to auto-enroll their workers, the bill clears up uncertainty surrounding default investments and allows financial firms to offer face-to-face investment advice to workers.

In spite of the boon it gives to 401(k) plans, the reform won't necessarily spark a mass exodus away from traditional pensions. "It depends on what kinds of employees companies want to attract," argues Rich of Segal Co.

A company with high turnover may not need to worry about providing a plan that gives workers a lot of retirement security. Meanwhile, one trying to attract mid-career engineers from a firm with a defined benefit plan will have a hard time doing so without a comparable program.